

Redacted to remove information specifically identifying interview respondents and statements not relevant to the Proposed Acceptable Practices.

Summary of Comments

As the interviews were conducted orally, the participants gave spontaneous responses. Different representatives of specific participants sometimes gave contradictory answers, and some individuals contradicted themselves. The interviewees' comments varied widely, but can be summarized in four major categories: (1) the effect of market changes on the futures industry, (2) exchange governance, (3) concerns over the disciplinary process, and (4) whether designated self regulatory functions should be passed to a "neutral" third party.

The Effect of Market Changes on the Futures Industry

The Commission asked the study participants for their thoughts on how market changes had affected the futures industry. Most recognized that the industry has been changing rapidly in the past few years, with the passage of the CFMA and the attendant rise in volume of futures trading.

The Effect of Demutualization

Some FCMs were apprehensive about exchange demutualization. These FCMs stated that a demutualized exchange would be continuously searching to maximize profits, which could cause an exchange to use its regulatory powers as a fee generator. [3 FCMs] [An industry representative] feared that the competitive pressures of exchange demutualization would cause exchanges to use audits as a weapon in competitive battles with FCMs. [An FCM] stated that demutualized exchanges are less interested in representative issues. Some FCMs and industry observers noted that competitive pressures could force exchanges to lower regulatory standards. [2 FCMs and 1 industry group]. They noted that competition could create a "race to the bottom" where exchanges would compete to offer the most lax regulatory scheme. [A federal regulator] stated that demutualization should not alter an exchange's duties as an SRO, however, [the regulator] noted that demutualization could create a greater potential for conflicts.

However, many of the FCMs stated that demutualization was a positive change in the futures industry. [3 FCMs] [Sentence omitted] [2 FCMs] Over time, [an FCM] stated, demutualized exchanges would become more corporate in their decision-making. Others suggested that this change might occur once ownership of shares of demutualized exchanges becomes more diffuse. [Sentence omitted] [Two FCMs] explained that demutualized exchanges would be more likely to focus on the good of the exchange and the exchange's share price, rather than the interests of floor traders. Changing the focus, they added, would ameliorate some of the more egregious conflicts.

Competition between exchanges and firms

Many FCMs stated that competition was occurring between exchanges and FCMs to some degree. [5 FCMs]. Some exchanges and FCMs thought that competition would increase in the future. [3 FCMs, 2 exchanges] The type of competition broke into two categories: exchanges offering direct access electronic screens to end users [3 FCMs] or FCMs offering competing services such as over the counter trading or internalization of orders or creating new exchanges, such as [an exchange]. [3 FCMs] FCMs stated that [an exchange] was introducing electronic screens to end users, which disintermediates FCMs. [2 FCMs] [One FCM] noted that [an exchange] had already introduced trading screens to end users in Europe and may do so in the United States. Exchanges noted that FCMs had created competing exchanges and many sought to trade products off-exchange, in competition with the exchange. [4 exchanges]

Some firms fear that competition will lead to retaliatory or punitive actions by exchanges acting in their regulatory capacities. [3 FCMs] For example, [an FCM] stated that hypothetically floor traders who served on disciplinary committees could retaliate against an FCM, if the FCM competed against the exchange and thus the floor traders, *i.e.*, by using [an exchange]. However, [that FCM] also noted that generally board and committee members “do the right thing” and that members involved in the decision making process have “common sense and would not allow individuals to abuse the process.” [An FCM] stated that exchanges may use audit information to obtain business products for new exchange services. [An FCM] expressed concern that firms with OTC trading could face adverse disciplinary panels. Concerns regarding the disciplinary process are discussed further below.

Most exchanges stated that taking FCM business or competing with FCMs was not in their business model. [4 exchanges] However, most recognized that competition was occurring, whether it was initiated by the exchanges or by the FCMs. [5 exchanges] The general consensus among the major exchanges was that FCMs competed with exchanges by trading OTC products or by developing their own exchanges, such as [an exchange or an exchange] [4 exchanges]. These exchanges also stated that FCMs would like to internalize order flow and compete with exchanges. [2 exchanges]. However, some exchanges stated that competition such as OTC trading was complementary to exchange business and helped build exchange trading. [3 exchanges]. [One exchange] concurred, stating that OTC trading brings their exchange more order flow.

Disintermediation

Another concern was that exchanges wished to disintermediate FCMs from the trading process. Most firms saw this as an issue, but were not able to clearly articulate why they thought that exchanges wished to disintermediate firms. Only two FCMs were able to point to a specific case of disintermediation: [Two FCMs] stated [an exchange’s] introduction of electronic trading screens to end-users was an attempt to disintermediate FCMs.

Exchanges strongly felt that intermediaries were a vital part of the futures industry. Characteristic of their responses was [an exchange], which stated that “intermediaries provide the oil” to run the exchange. [Four exchanges] similarly stated that exchanges need FCMs for

marketing products and order flow. [An exchange] stated that intermediaries provide credit and risk management.

Electronic trading

The rise of electronic trading has led to a rift between the floor and FCMs according to some FCMs. [3 FCMs] Some FCMs believe the rise of electronic trading is dangerous to the livelihoods of floor traders, and will cause them to act aggressively toward firms. [3 FCMs] These firms see locals using their dominance on governance boards to enact rules that hurt electronic trading. [3 FCMs] [An FCM] was particularly vociferous, stating that locals will “use any means available” to stop electronic trading. Some view domination of disciplinary committees by locals – who the firms see as hostile to trade electronically – as a possible or ongoing issue. [2 FCMs] [An FCM] stated it had been flooded by routine examinations of its [trades at an exchange], which it tied to [the exchange’s] disfavor of electronic trading.

Of the exchanges having significant electronic trading, the view was that they were promoting electronic trades. For example, [an exchange] stated that it was building an electronic trading education center to help floor traders learn about electronic trading. [Sentence omitted] [An exchange] stated that it was encouraging electronic trading by introducing new electronic systems, including [a system]. The interviewees at [an exchange] stated that locals at the other exchanges are evolving to electronic trading.

Exchange Governance

FCMs were very vocal about their perceived lack of representation at exchanges, particularly [three exchanges]. Many FCMs expressed the view that exchange governing boards and committees treat FCMs unfairly. [6 FCMs] Most FCMs interviewed thought exchange governance deprives them of a voice in the regulatory process. [8 FCMs] FCMs think members of the floor community dominate governance boards, and that this results in exchange rules favoring locals. [7 FCMs] One FCM stated that as exchanges are structured now, nominally “public” directors are often chosen by the board president, who is elected by locals, and thus cannot be relied upon to provide an independent viewpoint. [1 FCM]

Another view expressed was that the dominance of the exchange governance structure by locals creates a conflict – even if only perceived – that is bad for the industry. [3 FCMs] [An FCM] stated that one result of local-dominated governing boards was local-dominated settlement price committees.... This results in less accurate settlement prices because the settlement committee members favor their own positions in determining settlement prices. Exchange staff involvement in the setting of settlement prices was thought to yield more reliable results. [1 FCM]

To remedy this perceived bias, FCMs stated that governing boards should have balance among exchange participants. Some firms and industry observers think the Commission should apply pressure on exchanges to ensure diversity of interest and reduce conflicts of interest. [3 FCMs, 1 industry representative] However, other firms believe that market forces will eventually lead exchanges to diversify their boards. [2 FCMs] A few firms also suggested

requiring exchanges to select independent, public¹ directors to look out for the public interest. [2 FCMs] However, other firms believe that market forces will eventually lead exchanges to diversify their boards. [2 FCMs] However, other firms believe that the Commission should not impose regulations to force these changes. [2 FCMs] Similarly, some firms believed that growth of the markets, market forces, and competition would force changes in corporate governance. [4 FCMs] [Two industry groups] endorsed public directors at exchanges as well. Still other FCMs suggested that the public interest demands that the Commission revisit composition rules for governance boards. [2 FCMs] One firm recommended representation on exchange committees proportional to volume traded by the exchange member. [1 FCM] One firm questioned [an exchange] board's ability to govern independently given board members' high salaries. [1 FCM]

Exchanges do not see conflict in the governance process. [Three exchanges] stated that diverse representation exists on governing committees, and cited processes in place to ensure diversity. [3 exchanges]. Where FCMs see conflict, they want to pick their own representatives on exchange boards, stated one exchange. [1 exchange] Exchanges cited various reasons why FCMs lack representation on boards. [Two exchanges] stated that having FCM representatives on their board creates other conflicts, between the board members' fiduciary duty to the exchange and duty to the firms which employ the board member (and to competitive exchanges owned by such firms). [One exchange] noted that its experience with some FCMs on their board was a "disaster" because [the exchange] had discomfort discussing strategy with [competitor FCMs].

Two exchanges said if FCMs want more board representation they have the power/voting block to organize to elect their own representatives to governance boards. [2 exchanges] [An exchange] noted that [large FCMs] used to be more pro-active in submitting names of FCMs they wanted elected to the board. In the past few years, large FCMs have shown little interest in participating in exchange governance. [sentence omitted]

Nearly all of the exchanges, including all of the large exchanges, have rules or bylaws directing that the exchange board of directors represent a diversity of interests. Nevertheless, most FCMs stated that they do not feel that exchange boards truly represent a diversity of interests. [Sentence omitted] [An exchange] Similarly, [an exchange] stated that having a "professionally managed" exchange helped minimize conflicts. [An exchange] explained that separating regulatory functions from the business side of the exchange was essential to a functioning market. [Its] regulatory and non-regulatory staff is part of the exchange, but maintain a "Chinese wall." [A federal regulator] requires its exchanges to have public representation on at least half their board.

[Material not relevant to this Federal Register release omitted]

¹ Many of the firms used the terms "independent" and "public" interchangeably. Generally, the FCMs meant that they wanted someone who did not represent the floor trader's interest.

Disciplinary Process

Many FCMs see the disciplinary committee process as unfairly weighted against firms. FCMs allege non-diverse disciplinary committee makeup that is weighted toward the floor community, namely locals and brokers. [4 FCMs] It should be noted that the FCMs see a conflict between the interests of the locals *as a group* and the large FCMs *as a group* rather than simple conflicts between individual locals and individual FCMs (although there was occasional concern about the latter problem). Moreover, many of these FCMs indicated that committee members who were floor personnel nominally employed by an FCM were in fact oriented to the interests of the floor rather than their (temporary) employer. [3 FCMs] However, one [FCM] representative noted that FCMs and floor community disciplinary committee members bring different experiences to the table and committees generally do a good job with governing responsibilities.

Firms accuse locals of protecting each other's interests and focusing more on disciplinary actions against FCMs than against members of the floor community. [3 FCMs] Some firms believe that if members of the floor community dominate a committee, that committee might take disciplinary actions to send a message to the disciplined firm [2 FCMs] – a message that will be more pointed if the alleged violation involves upstairs trading or other specific acts considered inimical to the interests of the floor. One FCM suggested that it would be impossible for an electronic trading case to get a fair hearing before a disciplinary committee. [1 FCM] Many FCMs find diverse representation vital for disciplinary committee fairness. [2 FCMs] One FCM found the arbitration process needed reforming if FCMs are to be treated fairly. [2 FCMs] [An industry group] saw similar conflicts in exchange disciplinary committees, and recommended more Commission oversight of the committees. One FCM saw no unfair discipline by its SRO. [1 FCM] Although the FCMs made several allegations, no firm was able to offer any specific examples or evidence of wrongdoing by a disciplinary committee.

Firms generally indicated that they respected the professionalism and good faith of exchange staff, including in the disciplinary process. [3 FCMs] They generally did not reconcile this view with their concerns about exchange discipline, which is uniformly initiated by exchange staff. Many of the concerns expressed about unfair discipline were in the form of concerns about potential future cases rather than about specific allegedly unfair incidents that had actually occurred.

In addition to suggesting balanced membership, some FCMs advocated independent committee chairs to prevent biased committee actions. [2 FCMs] Securities exchanges tend to have professional hearing officers as chairs of hearing panels [1 exchange, 1 industry group] One FCM thought the Commission should require exchanges to create independent disciplinary and arbitration panels. [1 FCM] Some of those interviewed want the Commission to prescribe quotas to ensure diversity on committees. [1 industry representative, 1 FCM] One firm opposes any investigatory role for DSROs because of alleged biases. [1 FCM]

Exchanges see their disciplinary committees as fair and representative. Exchanges denied ever having seen a discriminatory disciplinary action. [4 exchanges] Many exchanges cited their commitment to diversity among various groups: FCMs/clearing firms, floor brokers,

floor traders, upstairs trading groups, and outside participants (non-members). [3 exchanges] In addition, [two exchanges] noted that disciplinary actions were driven by the professional staff, which is unlikely to have a bias. Disciplinary committee members at [two exchanges] noted they usually follow staff's recommendations. Exchanges noted that most disciplinary committee cases involve floor members, and that cases against firms are extremely rare, happening on average less than once a year. [3 exchanges] Clearing committees and financial surveillance committees with majority-FCM membership hear disciplinary actions involving financial problems at firms, and this ensures fair treatment of FCMs. [2 exchanges] Exchanges noted various means by which firms could appeal disciplinary committee decisions if firms feel mistreated. [2 exchanges]

[An exchange] and other exchanges rejected the idea that disciplinary committee members who are floor personnel employed by FCMs would hold an allegiance to the floor rather than to that committee member's employer. Exchanges see disciplinary committee membership as diverse and representative of both local firms and others. [4 exchanges] One exchange noted that disciplinary committee members are chosen for their industry expertise; this selection criterion would preclude selecting public directors of committees. [1 exchange] [Three exchanges] have public members on their disciplinary committees. However, some exchanges also suggested that having majority "public" disciplinary committee members would be ineffective, as they would tend to defer to those with expertise. [3 exchanges]

[One section omitted]

Transfer of Functions to a Third Party DSRO

Many of the FCMs thought that market forces would eventually correct the disciplinary and competitive issues. [3 FCMs] Some FCMs believe DSRO responsibilities should be delegated to a third party. [4 FCMs] The greatest FCM concerns involved the potential for conflict or for misuse of information by DSRO auditors. These FCMs say only a disinterested third party organization . . . can regulate fairly. They see exchanges as biased regulators who use their regulatory power for competitive ends. [A third party] was viewed as providing objectivity that exchanges lack. [4 FCMs, 2 industry representatives]

[An industry group] accused the exchanges of making self-interested decisions, and insisted that only an independent organization could regulate effectively. [sentence omitted] [An industry group] pointed to its public directors who have both independence and industry expertise. [A clearinghouse] agreed that exchanges should not perform DSRO functions due to exchanges' aggressive profit-seeking behavior and the conflicts that arise.

One firm suggested sending some regulatory functions such as dispute resolution to [a third party] and letting exchanges keep the investigatory function. [1 FCM] The same firm suggested transferring rulemaking power and clearing functions to [a third party]. [1 FCM]

Other FCMs reject the third party solution. They believe [a third party] lacks the experience necessary to assume the DSRO role. [1 FCM] They also expressed admiration for their own DSRO's expertise. [2 FCMs] Very few FCMs recommended delegating SRO

functions (*i.e.* – trade practice surveillance, market surveillance, rule enforcement) to a third party. [2 FCMs] DSROs and SROs rejected regulation by a third party. [6 exchanges] The exchanges like the current DSRO/SRO system. DSROs and SROs trust only their own staff to ensure market integrity, and believe regulation should remain with the exchanges. [7 exchanges] Regulatory function is integral to their business product, and it adds value to their brand name. Some exchanges, such as [two exchanges], found [a third party subject to] the same conflicts firms [have said exist at exchanges]. Most exchanges agreed that [a third party] lacks incentive to audit well, and lacks expertise and resources. [4 exchanges] Unlike exchanges, [a third party] risks only its reputation when it regulates, [and] does not suffer direct monetary loss if a firm goes under. [2 exchanges] Exchanges bear the financial burden if their auditing functions fail. [An exchange] stated that the “one size fits all” approach would ignore the smaller exchanges.

[2 sentences omitted] Exchanges trust only their own auditing staff to regulate firms and to manage risk, and exchanges wish to avoid creating new regulatory bureaucracy. [3 exchanges] Some exchanges would assign their own staff even if [a third party] were sole regulator. [3 exchanges] [One exchange] . . . found [a third party] to be a highly competent regulator, and saw the virtue of separating regulatory functions from exchanges.

Some exchanges emphasized the need for some type of division between SROs’ regulatory and non-regulatory functions. [7 exchanges] Some also agreed on the necessity of balance on governing boards. [2 exchanges] [An exchange] expressed many exchanges’ view that changes in the SRO system should be left to the marketplace. As [an exchange] noted, the Commission should not attempt to fix the DSRO system if it is not broken.

[Material not relevant to the proposed Acceptable Practices omitted]